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Tackling Taxes

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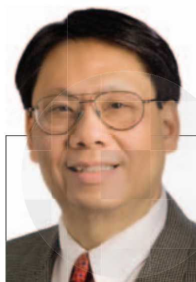
Tackling Disappearing Debt in Nontaxable Corporate Transactions—Part III



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In our April TAXES column, we explored the current and unsettled issues of debt extinguishment when a debtor transfers its debt to the creditor in certain nontaxable corporate transactions ("Debtor-to-Creditor Transfers") within a separate return context. The August TAXES column followed suit and examined the current unsettled income tax ramifications when a creditor transfers its debt to the debtor ("Creditor-to-Debtor Transfers") within the same context.

In this column, we will explore the income tax consequences of debt extinguishment in three types of nontaxable corporate transactions when both the debtor and creditor are members of a consolidated return group:

1. Transfers to controlled corporations under Code Sec. 351
2. Subsidiary liquidations under Code Sec. 332
3. Acquisitive reorganizations under Code Sec. 368(a)

Unless stated otherwise, both the transferor and the transferee corporations are solvent for purposes of this tax column.

Consolidated Return Rules on Intercompany Obligations

The income tax treatment of a debt extinguishment within a separate return context does not necessarily apply to intercompany obligations of members in a consolidated return group. An intercompany obligation is an obligation between members of a consolidated group, but only for the period during which both parties are members.[1] The obligation

could consist of either indebtedness or a security.[2] Whether indebtedness is respected as such is based on general income tax principles and does not include an executory obligation to purchase goods or services.[3] The general income tax consequences of an intercompany obligation are governed by Reg. §1.1502-13(g).

Under these regulations, a "deemed satisfaction and reissuance" regime is triggered when an intercompany obligation is involved in a "triggering transaction" unless an exception applies.[4] The deemed satisfaction and reissuance occurs immediately before, and independent of, the actual triggering transaction.[5]

The deemed satisfaction and reissuance regime also applies where an obligation that is not an intercompany obligation becomes an intercompany obligation (referred to as an "inbound transaction"). However, unlike the ordinary rules, the deemed satisfaction and reissuance is treated as occurring immediately after the inbound transaction event.[6] Unless stated otherwise, this column does not cover debt extinguishment of inbound transactions.

Income Tax Effects of Deemed Satisfaction and Reissuance Regime

Under the deemed satisfaction and reissuance regime, the debtor member is deemed to satisfy its obligation to the creditor member for an amount of cash equal to the debt's fair market value (FMV), and then immediately reissue a new debt (with the same terms and conditions as the actual debt, but a new holding period) to the same creditor member for the same amount of cash.[7]

In this deemed transaction, the debtor may have cancellation of indebtedness (COD) income under Reg. §1.61-12 or a repurchase premium under Reg. §1.163-7(c). Any COD income is not excludible under Code Sec. 108(a).[8] The creditor member may have a capital gain or loss on the debt satisfaction under Code Sec. 1271(a)(1). The capital gain or loss would generally be redetermined as ordinary income or loss under the matching rule in Reg. §1.1502-13(c). Under Reg. §1.1502-13(c)(4), the tax attribute of a separate member is redetermined to produce the same tax effect on consolidated taxable income as if the intercompany transaction had occurred between divisions of a single corporation. Generally, the attribute's character of the debtor's corresponding item controls the attribute's character of the creditor's intercompany item.[9] If it is an inbound transaction, however, the capital gain or loss recognized by the creditor is not redetermined.[10]

In summary, the deemed satisfaction and reissuance regime uses the FMV of the intercompany obligation as the standard of measure for determining the amount of income, gain, deduction or loss for both the debtor and creditor in a debt extinguishment or assignment. This typically results in income tax consequences that are symmetric for the debtor and creditor.

What Are Triggering Transactions?

The deemed satisfaction and reissuance regime applies only if there is a triggering transaction. Under Reg. §1.1502-13(g)(3), a transaction is a triggering transaction if:

- the transaction results in an intercompany obligation being assigned or extinguished (an "assignment and extinguishment transaction"); or
- the transaction changes an intercompany obligation to a non-intercompany obligation (an "outbound transaction").

As discussed above, while an inbound transaction is also subject to the deemed satisfaction and reissuance regime, it is not a triggering transaction within the meaning of Reg. §1.1502-13(g)(3). In order to have a triggering transaction, the relevant debt must be an intercompany obligation at the time of the transaction which, as defined above, is an obligation between members of a consolidated group during the period both parties are members of the consolidated group.

Extinguishment Is a Triggering Transaction

Extinguishment of an intercompany obligation is an assignment and extinguishment transaction. The regulations do not define the term "extinguishment." An obligation is generally extinguished when the debtor repays the creditor in satisfaction of the debt or when the debtor-creditor relationship ceases. A debtor-creditor relationship ceases when either the debtor or the creditor assigns the debt to the other, or when either the debtor or the creditor merges or liquidates into the other.

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Extinguishment of an intercompany obligation, being a triggering transaction, is subject to the deemed satisfaction and reissuance regime unless it falls within an exception listed in Reg. §1.1502-13(g)(3)(i)(B).

Nontaxable Corporate Transactions

Reg. §1.1502-13(g)(3)(i)(B) provides a number of exceptions to the deemed satisfaction and reissuance regime.[11] One such exception is applicable to nontaxable corporate transactions[12] and another is applicable to intercompany debt extinguishments.[13]

Each of these exceptions, however, is subject to a "tax benefit rule," which would override these exceptions if the transaction were "engaged in with a view to shift items of built-in gain, loss, income or deduction from the obligation from one member to another member in order to secure a tax benefit" that the group or its members would not otherwise enjoy in a consolidated or separate return year.[14] The term "tax benefit" is defined as the "benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance."[15]

Under the nontaxable corporate transaction exception, an intercompany transaction is generally not subject to the deemed satisfaction and reissuance regime if Code Sec. 361(a) or Code Secs. 332 and 337(a) apply and no income, gain, deduction or loss is recognized by the creditor or debtor. This exception is probably attributable to the fact that nontaxable corporate transactions generally relieve taxpayers from having to determine the FMV of all assets and the IRS did not want to separately impose such burden only on intercompany obligations. This exception does not apply if either the creditor or debtor recognizes income, gain, deduction or loss. The following example illustrates this exception.

Example 1—Merger of Debtor Member.

Facts. P is the parent corporation and directly owns 100 percent of B, C and S. B borrowed $100 from C in exchange for a note with adequate stated interest. In a subsequent year, B merges into S which qualifies as a reorganization within the meaning of Code Sec. 368(a)(1)(A) and (D). At the time of the merger, the note has a FMV of $110. Neither B nor C recognizes any income, gain, deduction or loss from the merger. The transfer of B's note to S does not constitute a significant modification within the meaning of Reg. §1.1001-3(e)(4).

Analysis. Reg. §1.1502-13(g)(3)(i)(B)(1) provides that the deemed satisfaction and reissuance regime does not apply to an intercompany exchange to which Code Sec. 361 applies, provided that no income, gain, deduction or loss is recognized from the exchange. Therefore, the nontaxable corporate transaction exception applies to deactivate the deemed satisfaction and reissuance regime.

This example assumes that the transfer of B's obligation in connection with the merger constitute neither a significant modification of the original debt under Reg. §1.1001-3(e)(4) nor a deemed exchange under Reg. §1.1001-3(b). If it does constitute an exchange, another exception known the "routine modification exception" under Reg. §1.1502-13(g)(3)(i)(B)(6) must also be satisfied in order for the deemed satisfaction and reissuance regime not to apply.

As a result, neither B nor C recognizes gain, income, deduction or loss from the debt transfer. S becomes the obligor on the note with a $100 issue price. C remains as the creditor of the note with an adjusted basis of $100.

For a Code Sec. 351 transaction in which no income, gain, deduction or loss is recognized by the creditor or debtor, the deemed satisfaction and reissuance regime also would not apply, but only if the transaction or any member of the consolidated group does not fall within any one of six prohibited categories listed in Reg. §1.1502-13(g)(3)(i)(B)(1)(i) through (vi). The intent of these six prohibited circumstances was to mandate a deemed satisfaction and reissuance transaction in the situations that would otherwise have the greatest potential to create distortions of consolidated taxable income.

Situations that are considered to have the greatest potential to distort consolidated taxable income involve (1) either a transferor or transferee member with a unique tax attribute or special tax status, (2) the use of preferred stock in the exchange, and (3) certain dispositions of the stock of a transferee member (or stock of a direct or indirect owner of the transferee member) within a short time after the exchange. Therefore, the deemed satisfaction and reissuance regime applies to any of the following six prescribed circumstances involving a Code Sec. 351 transaction:

1. Either the transferor or transferee member, but not both members, has a loss that is subject to limitation (*e.g.,* a SRLY loss under Reg. §1.1502-21(c) or a dual consolidated loss under Reg. §1.1503(d)(4)).
2. Either the transferor or transferee member, but not both members, has a special status (*e.g.,* a bank

as defined in Code Sec. 581 or a life insurance company as defined in Code Sec. 801).

3. A member of the group realizes COD income that is excluded under Code Sec. 108(a) within the same tax year as that of the transaction, and the tax attributes of either the transferor or the transferee are reduced under Code Secs. 108 and 1017 and Reg. §1.1502-28 (unless the attribute reduction is solely attributable to the rules of Reg. §1.1502-28(a)(4)).
4. The transferee has a nonmember shareholder.
5. The transferee issues preferred stock to the transferor in the exchange.
6. The stock of the transferee (or a higher-tier member that is not a member of an 80-percent chain of which the transferee is a member) is disposed of within 12 months from the debt transfer, unless (a) the transferor, transferee and debtor are all in the same 80-percent chain, and (b) all of the transferee's stock held by members is disposed of, directly or indirectly, to persons that are not members of the group.[16]

The nontaxable corporate transaction exception provided in Reg. §1.1502-13(g)(i)(B)(1) renders the deemed satisfaction and reissuance regime inoperative for many intercompany obligation transactions. However, this exception does not deactivate the deemed satisfaction and reissuance regime when an intercompany obligation is extinguished unless three additional requirements are also met.[17] In other words, when a debt is extinguished in a nontaxable corporate transaction under Code Sec. 332, 351 or 368, the debt extinguishment exception must also be satisfied in order to be relieved from the deemed satisfaction and reissuance regime. The extinguishment exception does not apply to a nontaxable corporate transaction if there is no extinguishment of an intercompany obligation. As illustrated in Example 1, another exception may be relevant to the transfer of an intercompany obligation that is not extinguished in the nontaxable corporate transaction.

Requirements for Debt Extinguishment Exception

An intercompany obligation that is extinguished in a nontaxable transaction under Code Sec. 332, 351 or 368 must satisfy three requirements under Reg. §1.1502-13(g)(3)(i)(B)(5). Otherwise, the extinguishment is subject to the deemed satisfaction and reissuance regime. These three requirements follow:

1. All or part of the rights and obligations under the intercompany debt are extinguished in an intercompany transaction (the "extinguishment requirement").
2. The adjusted issue price of the debt is equal to the creditor's adjusted basis in the debt (the "equal adjusted issue price and basis requirement").
3. After applying the special rules in Reg. §1.1502-13(g)(4)(i)(C), the creditor's intercompany item with respect to the debt completely offsets the debtor's corresponding item (the "offsetting item requirement").

The extinguishment requirement should be met whenever an intercompany obligation is extinguished in a nontaxable corporate transaction. However, depending on the facts, a transaction may fail one of the other two requirements.

The adjusted issue price of the debt is usually equal to the creditor's adjusted basis in such debt for a debt issued between members of a consolidated group. This is generally the case because an intercompany debt generally is not issued at a discount. Unless the creditor wrote down the basis of the debt as a Code Sec. 166 partial bad debt deduction, the adjusted issue price usually equals to the adjusted basis of the debt. However, a creditor may also reduce the intercompany debt basis under Code Secs. 108(b) and 1017 and Reg. §1.1502-28 as a reduction of tax attributes. This may occur if the creditor realized COD income but excluded the amount from income under Code Sec. 108(a). For purposes of this column, the adjusted issue price is equal to the adjusted basis of the intercompany obligation.

If the adjusted issue price and the adjusted basis of an intercompany obligation are equal, it seems that the creditor's intercompany item and the debtor's corresponding item should offset each other. Based on this interpretation, this third requirement seems redundant. Unless asymmetric tax positions are claimed by the creditor and debtor members, it seems that this offsetting item requirement should always be met whenever the equal adjusted issue price and basis requirement is met. Hence, this offsetting item requirement is intended to prevent members from taking asymmetric tax treatments that may result because of uncertain general tax principles on debt extinguishment in nontaxable corporate transactions.[18]

However, a deeper analysis of the offsetting item requirement makes it much more challenging to tackle as a result of the rules under Reg. §1.1502-13(g)(4)(i)(C).

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The effects of these particular rules are that Code Secs. 108(a), 354, 355(a)(1), 1091 and 351(a) are deactivated. In other words, these specified Code sections are not applicable in determining whether the offsetting item requirement is met. For example, the effect of Code Sec. 351(a) being turned off and rendered inoperative in an otherwise nontaxable transfer of a controlled corporation's debt in exchange for stock of the controlled corporation results in the debt for stock exchange being treated as a taxable exchange for purposes of the offsetting item requirement.

It should be noted that not all nontaxable Code sections applicable to nontaxable corporate transactions are turned off. For the nontaxable corporate transactions covered in this tax column, only Code Secs. 351(a) and 354 are rendered inoperative. Other Code sections are not deactivated. For example, neither Code Sec. 332, 337 nor 361 is turned off and, therefore, remain applicable.

A subsidiary liquidation remains subject to nontaxable treatments under Code Secs. 332 and 337. The income tax consequences of a debt extinguishment would be based on the general tax principles discussed in the April and August TAXES columns. Provided that the adjusted basis and the adjusted issue price are equal and no asymmetric tax treatments are claimed by the parent corporation and the liquidating subsidiary, the debt extinguishment should not be subject to the deemed satisfaction and reissuance regime.

In an acquisitive reorganization under Code Sec. 368, Code Sec. 361 remains operative for the acquired corporation, and Code Sec. 1032 remains operative for the acquiring corporation. As a result, the income tax consequences of debt extinguishment for both the acquiring and acquired corporations should also be based on the general tax principles discussed in the April and August TAXES columns.

Income Tax Treatment When Exception Applies

If a debt extinguishment is not subject to the deemed satisfaction and reissuance regime, the income tax consequences are determined based on the general tax principles applicable to the actual transactions. However, Reg. §1.1502-13(g)(4)(i)(C) still remains applicable in determining the income tax consequences.

The following examples illustrate the three requirements of the debt extinguishment exception under Reg. §1.1502-13(g)(3)(i)(B)(5) and the likely income tax consequences from the debt extinguishment. While these examples identify the FMV of the intercompany obligation for illustration purposes, FMV may not be necessary in many instances when a nontaxable corporate transaction is not subject to the deemed satisfaction and reissuance regime.

Example 2—Code Sec. 351/354 Exchange.[19]

Facts. S borrowed $100 from its parent corporation, P, in exchange for S's note with adequate stated interest. The note is a security within the meaning of Code Sec. 351(d)(2). S has fully performed on its obligations, but the note's FMV is $130 due to a decline in prevailing market interest rates. P transfers the note to S in an exchange to which both Code Secs. 351 and 354 apply. Code Sec. 351 applies because P is in control of S after the exchange and S's note is a security. If S's note is not a security, it would not be considered "property" under Code Sec. 351(d)(2). In addition, the exchange qualifies as a recapitalization under Code Sec. 368(a)(1)(E) because the note is a security within the meaning of Code Sec. 354(a)(1) and is exchanged for stock of S.

Analysis. An intercompany debt that is extinguished in a nontaxable transaction is not a triggering transaction subject to the deemed satisfaction and reissuance regime if the three requirements under Reg. §1.1502-13(g)(3)(i)(B)(5) are met.

First, the debt extinguishment requirement is met because S's note is effectively discharged upon the transfer. Second, the equal adjusted issue price and basis requirement should also be met because both the adjusted issue price and adjusted basis of S's note should be $100, the face amount of the note.

Lastly, the offsetting item requirement is met only if the income or deduction realized by the debtor offsets the same amount of deduction or income realized by the creditor. As directed by Reg. §1.1502-13(g)(4)(i)(C), both Code Secs. 351(a) and 354 are turned off and not operative for purposes of this requirement. As a result, the exchange is treated as a taxable transaction. On a separate return basis, P would realize $30 ($130 less $100 basis) of capital gain under Code Secs. 1001 and 1271(a)(1), and S would realize a $30 interest deduction under Reg. §1.163-7(c). However, the matching rule under Reg. §1.1502-13(c)(4)

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redetermines P's capital gain to $30 of ordinary gain. In effect, P's ordinary gain of $30 offsets S's $30 of ordinary interest deduction. Hence, the offsetting item requirement is met, and the deemed satisfaction and reissuance regime should not apply.

Because the deemed satisfaction and reissuance regime does not apply, the actual income tax treatment is determined on the actual transaction, again taking into account those specified nontaxable provisions that are deactivated under Reg. §1.1502-13(g)(4)(i)(C) and the matching rule under Reg. §1.1502-13(c)(4). This would result in ordinary gain of $30 for P and a corresponding ordinary premium deduction of $30 for S.

Note that measuring the debt at FMV is the appropriate standard of measure because the transaction is taxable as a result of turning off Code Secs. 351(a) and 354.

Example 3—Code Sec. 351 Exchange.

Facts. Assume same facts as Example 2, except that note has an FMV of $90 at the time P transfers the note to S in exchange for S's stock.

Analysis. Similar to Example 2, the first two requirements of Reg. §1.1502-13(g)(3)(i)(B)(5) are met. For the offsetting item requirement, Code Secs. 351 and 108(a) are turned off. As a result, S recognizes COD income of $10, and P recognizes a capital loss of $10 under Code Secs. 1001 and 1271(a)(1). Because of the matching rule under Reg. §1.1502-13(c)(4)(i), P's capital loss of $10 is recharacterized as ordinary loss. The offsetting item requirement is met since S's COD income of $10 offsets the same amount of P's ordinary loss. Hence, the deemed satisfaction and reissuance regime does not apply.

Because the deemed satisfaction and reissuance regime does not apply, the actual income tax results are based on the actual transaction. With Code Secs. 351 and 108(a) not applicable, S has $10 of COD income and P has $10 of ordinary loss.

It should be noted that in *Lidgerwood Mfg. Co.,*[20] a loss was disallowed and added to the basis of the stock held by the creditor-shareholder. It is assumed that *Lidgerwood* would not apply because it would be anomalous that the IRS would issue regulations to turn off a nonrecognition Code section to trigger a loss that would not have been recognized, but then disallow the loss under *Lidgerwood*.

Example 4—Code Sec. 368 Reorganization.

Facts. P is the parent corporation of B and C. B borrowed $100 from C in exchange for a note bearing adequate stated interest. In a later year, B transfers its assets and liabilities (including B's note) to C in a nontaxable Code Sec. 368(a)(1)(D) reorganization. At the time of the transfer, the note has a FMV of $90.

Analysis. Provided that the adjusted issue price of B's note equals to the adjusted basis in the hands of P, the first two requirements are met.

In a nontaxable reorganization, neither Code Sec. 361 nor 1032 is turned off. Under Code Sec. 357(a), B would not recognize any gain or COD income on its note. On a separate return basis, it is unsettled whether C has any gain or loss on the extinguishment of B's note. However, C should not have net taxable income or loss in a consolidated return context.

Based on the principles of symmetry and the lack of wealth enrichment, C should not have any gain or loss from the debt extinguishment. If based on the principles of *Kniffen*,[21] C would be treated as assuming B's note as the successor debtor. C could then be viewed as having $10 of COD income from a deemed repayment of B's note because the FMV of the note is $90 and the adjusted issue price is $100. Under this analysis, C should also have a loss of $10 as a creditor on the deemed debt repayment. Under *Kniffen* principles, C should also have no income or loss because the $10 loss is offset by the $10 COD income.

Under the analysis described above, the deemed satisfaction and reissuance regime should not apply because the offsetting item requirement is satisfied.

As a result of the deemed satisfaction and reissuance regime not applying, the income tax consequences of the debt extinguishment should then be determined based on the actual transaction. Under general tax principles and the consolidated return matching rule, neither B nor C should recognize any net taxable income or loss from the extinguishment of B's note.

While FMV is provided in the example for illustration purposes, it should not be required or needed to determine the income tax consequences.

Example 5—Code Sec. 368 Reorganization.

Facts. Assume the same facts as Example 4, except that the direction of the reorganization is

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reversed and C transfers its assets (including B's note) and liabilities to B in a nontaxable Code Sec. 368(a)(1)(D) reorganization.

Analysis. The first two requirements should still be met, assuming the adjusted issue price and the adjusted basis of B's note are equal.

The third requirement of offsetting items should also be met. Neither Code Sec. 361 nor 1032 is turned off under Reg. §1.1502-13(g)(4)(i)(C). Hence, C should have no gain or loss on the transfer of B's note under Code Sec. 361(a). B should have no gain or loss under Code Sec. 1032 for issuing its stock for the transfer. Based on Rev. Rel. 74-54,[22] B should also have no gain or loss from the debt extinguishment.

If based on *Kniffen* principles, B would be treated as if it first received the note from C as a successor creditor and then, as the debtor, repaid the note. B would be treated as the debtor and the successor creditor. Under this scenario, B, being the debtor, would have COD income of $10 because the adjusted issue price of $100 is more than the FMV of $90. As a successor creditor, B should be entitled to an ordinary loss of $10. The net result is that B has no taxable income because the COD income of $10 is offset by the $10 of ordinary loss. Hence, the offsetting item requirement is met and the deemed satisfaction and reissuance regime should not apply.

Based on general tax principles and the matching rule, neither B nor C recognizes net taxable gain or loss from the extinguishment of B's note. FMV is provided for illustration purposes only.

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Example 6—Code Sec. 332 Liquidation.

Facts. S borrowed $100 from P, its parent corporation, in exchange for S's note with adequate stated interest. In a subsequent year, S liquidated under Code Sec. 332 and distributed all of its assets and liabilities (including its note) to P. Due to an increase in prevailing interest rates, the note's FMV was $90 at the time of liquidation.

Analysis. The first two factors are met, assuming that the adjusted issue price and adjusted basis of the note are equal.

The offsetting item requirement should also be met. Neither Code Sec. 332 nor 337 is turned off by Reg. §1.1502-13(g)(4)(i)(C). Based on Code Sec. 337(b), no gain or loss should be recognized by S on the distribution of its note to P. On a separate return basis, it is unsettled if P should have gain or loss on the debt extinguishment. However, P should not have taxable income or loss in a consolidated return context. If P were treated as the successor debtor of S's note upon liquidation, P would have COD income on the debt extinguishment to the extent that the note's FMV of $90 is less than the adjusted issue price of $100. But P should also have a loss of same amount as the creditor of the note. Under the consolidated return matching rule, the $10 loss would be an ordinary loss. As a result, P should have no net taxable income or loss on the debt extinguishment. Therefore, the deemed satisfaction and reissuance regime should not apply.

The income tax consequences should be determined based on the actual transaction. Under general tax principles and the matching rule, neither P nor S should recognize net taxable income or loss from the debt extinguishment. FMV is provided for illustration purposes only.

Example 7—Code Sec. 332 Liquidation.

Facts. Assume the same facts as Example 6, except that P borrowed $100 from S. At liquidation, P received its own note from S.

Analysis. The first two requirements are met, assuming the adjusted issue price and the adjusted basis are the same.

The third requirement should also be met. Under Code Sec. 337(a), no gain or loss should be recognized by S on the liquidating distribution of P's note. Based on Rev. Rul. 74-54, P should not recognize gain or loss from the extinguished debt. If P were treated as the successor creditor of the note upon liquidation, P would have a loss to the extent that the FMV of the note is less than the adjusted basis of the note. Being the debtor of such note, P would also have COD income of the same amount. As a result, P should have no net taxable income or loss from the debt extinguishment. Therefore, the deemed satisfaction and reissuance regime should not apply.

Based on general tax principles and the matching rule, neither P nor S should recognize net taxable income or loss from the actual debt extinguishment. FMV is provided for illustration purposes only.

Capital Contribution Under Code Sec. 108(e)(6)

One interesting issue is how a capital contribution of debt from a creditor parent to a debtor subsidiary described in Code Sec. 108(e)(6) should be treated in a consolidated return context. Does the deemed satisfaction and reissuance regime apply to a capital contribution?

A capital contribution of debt should be a triggering transaction subject to the deemed satisfaction and reissuance regime unless it falls within the exception under Reg. §1.1502-13(g)(3)(i)(B). Although no stock is issued in a capital contribution, the meaningless gesture doctrine may apply to treat the transaction as a Code Sec. 351 transfer.[23]

Because a capital contribution is an intercompany extinguishment transaction, the three requirements under Reg. §1.1502-13(g)(3)(i)(B)(5) must be met before the capital contribution can be excluded from being treated as a triggering transaction subject to the deemed satisfaction and reissuance regime. An issue in applying the offsetting item requirement is whether Code Sec. 351(a) is turned off under Reg. §1.1502-13(g)(4)(i)(C) for a capital contribution. The regulations specify that Code Sec. 351(a) is turned off "in the case of an extinguishment of an intercompany obligation in a transaction in which the creditor transfers the obligation to the debtor *in exchange for stock in such debtor*" (emphasis added). This seems to imply that nontaxable treatment under Code Sec. 351(a) is turned off only in cases where the extinguished debt is actually exchanged for stock, even if the issuance of additional shares is a meaningless gesture.

This interpretation of actual stock exchange is analogous to the IRS letter rulings holding that the form of the transaction is respected and governs whether a transaction is a capital contribution subject to Code Sec. 108(e)(6) or a stock exchange under Code Sec. 108(e)(8).[24]

As discussed in the August TAXES column, no COD income is recognized by the debtor under Code Sec. 108(e)(6) and no gain or loss is recognized by the creditor under Code Sec. 351(a) if the adjusted issue price and the adjusted basis of the debt are equal. Under Code Sec. 108(e)(6), there is no COD income if the extinguished debt's adjusted issue price and adjusted basis are equal. Therefore, it seems that the offsetting item requirement and the other two requirements under Reg. §1.1502-13(g)(3)(i)(B)(5) can be met if the adjusted issue price and the adjusted basis of the contributed debt are equal and Code Sec. 351(a) is not turned off.

It seems clear that a capital contribution of an intercompany debt should not be subject to the deemed satisfaction and reissuance scheme if the three requirements in Reg. §1.1502-13(g)(3)(i)(B)(5) are met. However, it is not entirely clear whether Code Sec. 351(a) is turned off in a capital contribution. Still, even if Code Sec. 351(a) did not apply, the deemed satisfaction and reissuance regime would ensure that any deemed or actual COD income would be offset by a deemed or actual bad debt deduction in the consolidated return (*see* Examples 2 and 3 above). Therefore, while consolidated taxable income is the same under both scenarios (*i.e.*, with or without Code Sec. 351(a)), the separate taxable income of each member may differ which, among other ramifications, could have significant state and local income tax consequences. Further guidance on this matter is welcome.

Application of the Deemed Satisfaction and Reissuance Regime

The above discussion shows that in most instances the deemed satisfaction and reissuance regime does not apply to the extinguishment of intercompany obligations if the obligation's adjusted basis and adjusted issue price are equal in amount. Typically, the adjusted basis and the adjusted issue price of an intercompany obligation are equal in amount because such obligation typically is not issued or acquired at a discount.

In instances where the adjusted basis and adjusted issue price are not equal in amount, the deemed satisfaction and reissuance regime is applicable. One instance where these two tax attributes are not equal is the result of a basis adjustment under Code Sec. 108(b) and Reg. §1.1502-28.

Example 8—Triggering Transaction.

Facts. B borrowed $100 from C. In a subsequent year, C realized COD income that was excluded under Code Sec. 108(a). Pursuant to Code Sec. 108(b) and Reg. §1.1502-28, C may reduce the adjusted basis of B's note.

Analysis. Under Reg. §1.1502-13(g)(3)(i)(1), a reduction of an intercompany obligation's

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adjusted basis under Code Secs. 108 and 1017 and Reg. §1.1502-28 is not a triggering transaction. In such instance, the adjusted issue price of the note would be greater than the adjusted basis. If B's note is extinguished at a later date, the extinguishment will be treated as a triggering transaction subject to the deemed satisfaction and reissuance regime.

Example 9—Triggering Transaction and Deemed Satisfaction and Reissuance.

Facts. P is the parent corporation of B and C. B borrowed $100 from C in exchange for a note with adequate stated interest. In a subsequent tax year, C realized COD income of $30 that was excluded from income under Code Sec. 108(a). Pursuant to Reg. §1.1502-28, the adjusted tax of B's note is reduced from $100 to $90. As a result of this basis adjustment, the adjusted issue price of the note is $100, and the adjusted basis is $90. In a later year when C is solvent, C transfers its assets (including B's note) and liabilities to B in a nontaxable reorganization. The FMV of the note is $90 at the time of the reorganization.

Analysis. Because the three requirements under Reg. §1.1502-13(g)(3)(i)(B)(5) are not met, the debt extinguishment is a triggering transaction under Reg. §1.1502-13(g)(3)(i)(A)(1) and therefore is subject to the deemed satisfaction and reissuance regime under Reg. §1.1502-13(g)(3)(ii).

As a result, B's note is treated as satisfied for $90 immediately before the reorganization. B, as the debtor, recognizes COD income of $10 under Reg. §1.61-12 because the debt's adjusted issue price is $100. Even if B was ordinarily able to exclude this COD from income under Code Sec. 108(a), this would not be permitted on COD income generated from the deemed satisfaction and reissuance under Reg. §1.1502-13(g)(4)(i)(C). C, as the creditor, recognizes no gain or loss because the FMV of the debt, $90, equals the adjusted basis of $90.[25]

Under Reg. §1.1502-13(g)(3)(ii), B's note is then deemed reissued by B for $90 immediately after the satisfaction. The new note would have a $90 issue price, $100 stated redemption price at maturity, and $90 basis in the hands of C. C is then treated as transferring this new note, along with its other assets and liabilities, to B in the actual reorganization. The new note is then deemed extinguished. There should be no gain or loss to B or C on the actual debt extinguishment since the adjusted basis, adjusted issue price and FMV of the new note are equal in amount.

Observations and Conclusion

What are the income tax consequences of all these consolidated return rules on debt extinguishments involving intercompany obligations? It seems that these regulations attempt to provide symmetric income tax treatments for the debtor and creditor members. With the deemed satisfaction and reissuance regime, the debtor and the creditor should have corresponding, offsetting income and deduction items. While the deemed satisfaction and reissuance regime is shut off for many debt extinguishments occurring in nontaxable transactions, the consolidated taxable income at the time of debt extinguishment should still be the same (*i.e.,* corresponding offsetting income and deduction items for the debtor and the creditor). The fact that consolidated taxable income is the same in these transactions is precisely the reason why the deemed satisfaction and reissuance regime can be turned off in these transactions.

This attempt to provide symmetric income tax treatments furthers the purpose of the intercompany transaction rules to prevent such transactions from creating, accelerating, avoiding or deferring consolidated taxable income. It is a worthwhile endeavor and more equitable than the potential asymmetry of income tax consequences in the separate tax return context if either debtor or creditor is required to report income, but there is no offsetting deduction for the debt extinguishment.

Endnotes

* This column represents the views of the authors, and does not necessarily represent the views or professional advice of Plante Moran.

1 Reg. §1.1502-13(g)(2)(ii).

2 Reg. §1.1502-13(g)(2)(i).

3 Reg. §1.1502-13(g)(2)(i)(A).

4 While several exceptions are discussed later in this column, the regulations contain a rather extensive set of exceptions to the deemed satisfaction and reissuance treatment and also provide for modifications to the general rule in a number of other circumstances. A detailed discussion of these exceptions and variations is beyond the scope of this column.

ENDNOTES

[5] Reg. §1.1502-13(g)(3)(ii)(B).
[6] *See* Reg. §1.1502-13(g)(5).
[7] Reg. §1.1502-13(g)(3)(ii)(A).
[8] Reg. §1.1502-13(g)(4)(i)(C).
[9] *See* Reg. §1.1502-13(c)(4)(i).
[10] Reg. §1.1502-13(g)(6)(i)(B).
[11] Another exception, known as the "routine modification exception," may also be relevant to an intercompany obligation in a nontaxable corporate transaction. *See* Reg. §1.1502-13(g)(3)(i)(B)(6). This exception does not apply to debt extinguishment and is not discussed further in this column.
[12] *See* Reg. §1.1502-13(g)(3)(i)(B)(1).
[13] *See* Reg. §1.1502-13(g)(3)(i)(B)(5).
[14] *See* Reg. §1.1502-13(g)(3)(i)(C).
[15] *See* Reg. §1.1502-13(g)(2)(v).
[16] An 80-percent chain is defined by Reg. §1.1502-13(g)(2)(vi) as "a chain of two or more corporations in which stock meeting the requirement of section 1504(a)(2) of each lower-tier member is held directly by a higher-tier member of such chain."
[17] *See* Reg. §1.1502-13(g)(3)(i)(B).
[18] *See* the April and August TAXES columns for further discussion.
[19] This example is a slightly modified version of Reg. §1.1502-13(g)(7)(ii), Example 6.
[20] *Lidgerwood Mfg. Co.,* CA-2, 56-1 USTC ¶9214, 229 F2d 241.
[21] *A.L. Kniffen,* 39 TC 553, Dec. 25,807 (1962).
[22] 1974-1 CB 76.
[23] *See, for example, S. Lessinger,* 85 TC 824, Dec. 42,489 (1985) and Rev. Rul. 64-155, 1964-1 CB 138.
[24] *See* LTR 200537026 (Sept. 16, 2002), LTR 9830002 (Mar. 20, 1998), LTR 9623028 (Mar. 7, 1996), LTR 9404014 (Oct. 26, 1993) and LTR 9024056 (Mar. 2, 1990).
[25] *See* Reg. §1.1502-13(g)(4)(i)(A) and (B).

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